No. 3862.

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

In the Matter of

ELLIOTT-O'BRIEN COMPANY, a Corporation, Bankrupt;

S. G. CLIMENSON, as Trustee of ELLIOTT-O'BRIEN COMPANY, a Corporation, Bankrupt, *Appellant,*

vs.

CARSON, PIRIE, SCOTT & COMPANY, a Corporation; COFFMAN, DOBSON BANK & TRUST COMPANY, a Corporation; BEE NUGGET PUBLISHING COMPANY, a corporation, *Appellees.*

REPLY BRIEF OF APPELLANT

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Attorney for Appellant.

INSOLVENCY UNDER BANKRUPTCY ACT.

Counsel for the Bank does not question the Referee's finding that the bankrupt was insolvent in the bankruptcy sense, namely, that its liabilities were in excess of assets from December, 1920, to adjudication in May, 1921.

Counsel for Carson, Pirie, Scott & Co. questions the correctness of the Referee's finding on the question of insolvency in the bankruptcy sense; especially questioning the finding that "in December, 1920, the bankrupt owed for merchandise about $16,240.92, and owed the Bank $5500.00, making a total known indebtedness of $21,740.92."

The Referee's findings are based on the record showing the total indebtedness for merchandise past due and not due on December 31, 1920, was $16,240.92 (R-69) and that the indebtedness to the Bank on December 31, 1920, was $5500.00 (R-52).

The next criticism of Counsel is that the Referee found the assets to be $26,371.39, including fixtures of $3520.00.

Counsel refers to a financial statement issued by the bankrupt on December 31, 1920, which showed the following assets:

Inventory	$27,862.25
Book accounts	1,894.07
Fixture accounts	3,520.22, etc.

If there was no other evidence on the subject counsel might argue that the assets did exceed the amount fixed by the Referee, but the record shows that the merchandise was inventories on a cost basis on December 31, 1920, and that there was deducted $2500.00 or $2700.00 which the bankrupt claimed brought it down to market value (R-67). In view of the testimony showing that the value of merchandise rapidly declined in the Fall of 1920 (R-43, 44, 75), and the testimony of the Receiver that values had declined at least 25% (R-21, 83, 84), and in view of the common knowledge that the period was one of drastic deflation and that merchandise actually declined 30-32% in October, 1920, it appears that a reduction of $2700.00 was wholly inadequate and that the figures of the Referee in fixing the amount of assets was very liberal toward Appellees.

Average Retail Price of 10 Articles of Dry Goods on May 15, August 15, October 15, 1920, and on February 15, May 15, 1921.

Seattle, Washington.

		1920			1921	
ARTICLE.	Unit.	May 15	Aug. 15	Oct. 15	Feb. 15	May 15
Calico, 24 to 25 inch	Yard	$0.250	$0.317	$0.250	$0.150	$0.145
Percale	Yard	.520	.571	.470	.317	.283
Gingham, apron, 27 to 28 inch	Yard	.350	.358	.330	.192	.192
Gingham, dress, 27 inch	Yard	.419	.443	.439	.259	.244
Gingham, dress, 32 inch	Yard	.700	.741	.750	.543	.537
Muslin, bleached	Yard	.500	.481	.351	.251	.235
Sheeting, bleached 9-4	Yard	1.177	1.175	1.119	.708	.708
Sheets, bleached, 81 by 90	Each	3.118	3.005	2.895	1.800	1.785
Outing flannel, 27 to 28 inch	Yard	.441	.456	.435	.263	.237
Flannel, white wool, 27 inch	Yard	1.467	1.575	1.575	1.225	1.288
Blankets, cotton, 66 by 80	Pair	6.071	5.790	5.825	4.700	4.479

The foregoing tabulation is taken from public documents of the Government Printing Office issued by the Department of Labor in its Monthly Labor Review (October, 1921-December, 1921) of the Bureau of Labor Statistics, U. S. Department of Labor, entitled "Price and Cost of Living." Also see Monthly Labor Review, Vol. 15, No. 2 (August, 1922, pg. 63), issued by the U. S. Department of Labor, Bureau of Labor tSatistics, covering prices on same articles of merchandise under date of February 15 and May 15, 1921.

Fall and Winter merchandise was undoubtedly purchased during the Summer of 1920 and the table

above shows that calico had declined from the August figure of $0.317 to $0.250 on October 15, a decline of 21%; to $0.150 on February 15, a decline of 52%; and to $0.145 on May 15, a decline of 54% from August 15, 1920, figures.

Percale sold for $0.571 on August 15 and dropped to $0.470 or 17% on October 15; to $0.317 or 44% on February 15; to $0.283 or 50% on May 15.

Apron gingham sold for $0.358 on October 15, 1920, and declined to $0.330 or 7% on October 15; to $0.192 or 46% on February 15; and to $0.192 or 46% on May 15.

Dress gingham sold on August 15, 1920, for $0.741, on October 15 for $0.750, an increase of 1%; on February 15, 1921, for $0.543, a decline of 26%; on May 15 for $0.537, a decline of 27%.

Bleached muslin sold on August 15, 1920, for $0.481, on October 15 for $0.351, a decline of 27%; on February 15, 1921, for $0.251, a decline of 48%; on May 15 for $0.235, a decline of 51%.

Without giving actual figures on balance of the items a calculation of all the items together will show an average decline from prices on August 15,

1920, as follows:

Decline on October 15, 1920.... 3%
Decline on February 15, 1921..30%
Decline on May 15, 1921..........32%

Accordingly the inventory of merchandise showing $27,862.25 was subject to a reduction of 30%, or $8,358.68. The value of the goods purchased new and fresh from wholesalers was $19,503.57. It is a matter of common knowledge that stocks offered for sale never bring full wholesale value and hence the stock was actually worth less, and the record shows that the bankrupt had offers of but 60% for the merchandise (R. 136, 137).

The value to be placed on the merchandise must be its value at the time and place under consideration The business conditions existing at Chehalis was described as demoralized (R. 128) and there was absolutely no business—business was at a standstill (R. 75); it was "at a time of serious financial depression when buyers of merchandise stocks would be comparatively few and cautious in bidding" (Carson brief pg. 20).

The statement of the Carson brief on Page 17 "that the debtor company had a net worth of $2945.07 on April 26, 1921, as shown by the entries in its trial balance book (Trustee's Exhibit B) of

that date and based upon an actual inventory made by Mr. Elliott between the dates of April 23 and 26th," is erroneous. At that time Mr. Elliott took an inventory and estimated the value of the merchandise. He left on April 26, his successor, Mr. Hart, completed the inventory by placing actual market values upon the merchandise and when he had completed it he brought it to Mr. LeSourd on May 2nd, and it appeared that the liabilities were greatly in excess of assets (R. 41). Thus the inventory taken the last of April upon actual market value—replacement figures—shows plainly the unreliability of the figures Elliott kept in his books. In short, all inventories of merchandise taken upon cost prices were about 50% higher than inventories taken at market prices, which is the price at which the same merchandise could be replaced by buying in the open market. The so-called discrepancy, of which Counsel complains, is the difference in value of merchandise in the open market and what the same merchandise had actually cost the bankrupt at the time it was purchased during the year preceding the decline in values occurring in the Fall of 1920.

The Bankruptcy Act requires the Referee to place a fair valuation upon all assets, not a nominal

or paper valuation which the books may show. Sec. 1 (15), of the Bankruptcy Act provides:

> "A person shall be deemed insolvent within the meaning of this Act whenever the aggregate of his property shall not at a fair valuation be sufficient in amount to pay his debts."

A fair valuation is the fair, market price which a seller willing to sell would accept from a buyer willing to buy at that price.

> *Grandison vs. Bank,* 231 Fed. 800, 806 (2nd C. C. A.).

The unreliability of financial statements showing true and actual assets is noted in

> *Conover vs. Hull,* 10 Wash. 673, Page 686, 30 Pac. 166.

The record further shows that it was understood that the values placed upon the merchandise by Mr. Elliott were exaggerated. Mr. LeSourd wrote Mr. Abel on April 9, 1921, that:—

> "The inventory is without a doubt much too high and there is grave question whether or not the business will more than pay the indebtedness and it has been decided to carry on a closing out sale and liquidate the corporate business in that way" (R. 132).

STATE LAW PROHIBITING PREFERENCES BY INSOLVENT CORPORATIONS.

Are the Rights of the Trustee in This Proceeding Confined to the Provisions of 57-G, 60-B, 67-E, Construed in Conjunction?

Under this heading Appellees argue that the right of the Trustee to object to their claims are found in said sections only. It is worthy of note that no case in point or text sustains the contention of Appellees. The case cited by Appellees

> *Western Tie & Timber Co. vs. Brown,* 196 U. S. 502

does not sustain their contention but does sustain Appellant. The Supreme Court held the lower court erred in refusing to permit the creditor to prove his claim under Sec. 57-g but held that the right of set-off was proper. The court said:

> "The result will be that the Tie Company will be a creditor of the estate for the whole amount of its claim, and will be, at the same time, a debtor to the estate for the amount of the deductions from the pay rolls collected by it, the court below, of course, having power to take such steps as may be lawful to protect the

> estate in respect to payment of dividends to the Tie Company, in the event that company does not discharge its obligations to the bankrupt estate."

So here Appellees may prove the full amount of their claims and at the same time are debtors to the estate for payments received contrary to the law of the State which the court will protect by proper orders relating to payment of dividends.

Sec. 2 of the Bankruptcy Act provides:

> "That the courts of bankruptcy as hereinbefore defined * * * are hereby invested * * * with such jurisdiction at law and in equity as will enable them to exercise original jurisdiction in bankruptcy proceedings, in vacation in chambers and during their respective terms, as they are now or may be hereafter held, to * * * (2) allow claims, disallow claims, reconsider allowed or disallowed claims, and allow or disallow them against bankrupt estates."

Sec. 57-D:

> "Claims which have been duly proved shall be allowed, upon receipt by or upon presentation to the court, unless objection to their allowance shall be made by parties in interest, or their consideration be continued for cause by the court upon its own motion."

Sec. 57-F:

> "Objections to claims shall be heard and determined as soon as the convenience of the court and the best interest of the estates and the claimants will permit."

Sec. 57-G:

> "Claims of creditors who have received preferences, voidable under section sixty, subdivision b, or to whom conveyances, transfers, assignments, or incumbrances, void or voidable under section sixty-seven, e, have been made or given, shall not be allowed unless such creditors shall surrender such preferences, conveyances, transfers, assignments, or incumbrances."

The Trustee's rights are found in the following Sections of the Act:

Sec. 8 of the Act of June 25, 1910, amending Sec. 47, cl. 2 of Act of 1898, provides that a Trustee:—

> "Shall be deemed vested with all the rights, remedies, powers of a judgment creditor holding an execution duly returned unsatisfied."

Sec. 60-B authorizes the Trustee to set aside the statutory preference defined by the Act in said section.

Sec. 67-A, B, C, nullifies certain liens, including liens obtained by legal proceedings within four months.

Sec. 67-E provides that all conveyances within four months made with intent to defraud shall be null and void except as to purchasers in good faith for present fair consideration. Also that all conveyances within four months during insolvency

which are null and void as against creditors by State law shall be null and void as against the Trustee.

Sec. 70-A confers upon the Trustee the title of the bankrupt; Sec. 70-A(4) gives the Trustee title to property transferred by bankrupt in defraud of creditors.

Sec. 70-E, authorizes the Trustee to avoid any transfer by the bankrupt of his property which any creditor might have avoided and confers jurisdiction upon courts of bankruptcy.

Careful consideration of these sections shows the rights of a Trustee are three-fold: (1) Under Sec. 70-A the Trustee has all the title that the bankrupt had; (2) under Sec. 70-A(4), and 70-E, Sec. 67-B, and Sec. 47-(2), the Trustee has all the rights that creditors of the bankrupt had; (3) the Trustee has the peculiar rights created by the statute as to preference in 60-B, nullifying liens obtained by legal proceedings within four months while insolvent under 67-C; and 67-E, avoiding all transfers within four months made with intent to defraud and also all conveyances within four months while insolvent which are null and void as against creditors.

In creating these special statutory rights found in Sec. 60-B relating to preferences and in 67-E relating to fraudulent conveyances under specified terms and conditions the Congress provided in both Section 60 and 67 that for the purpose of recovering such preferences or such fraudulent transfers that Courts of Bankruptcy and State Courts should have concurrent jurisdiction and also provided in Sec. 57-G that the claims of any creditors who had received such preferences or such voidable transfers should not be allowed unless same were surrendered. Since the right of the Trustee as to preferences defined in 60-B and the right to avoid conveyances defined in 67-E were of purely statutory origin and creation, it was necessary that the Act should expressly provide for the enforcement of such right both for the purpose of recovery and for the purpose of defense. Hence, express provision is made by Sections 60 and 67 for suit by the Trustee in either Courts of Bankruptcy or in the State Court and the right to defend against claims on file is expressly given by Section 57-G.

The right of the Trustee to object to claims on file on any ground which the bankrupt might have asserted or which creditors might have asserted is expressly given by Sec. 70-A, 70-E, 67-B, taken to-

gether with Sec. 47-(2). The right of the Trustee to object to claims filed with the Referee under Sec. 70-E on the ground that a creditor has received a preference prohibited by State law is well established in

Irwin vs. Maple, 252 Fed. 10, (6 C. C. A.).

In re. Creech Bros. Lumber Co., 240 Fed. 8 (9 C. C. A.).

Objections by a Trustee to claims setting up practically every defense known to the law are found in a multitude of cases set out in Remington on Bankruptcy, (2nd Edition), Sec. 803, 803½, 1193 to 1202 inc. citing cases where the Trustee set up such defenses as statute of limitations, statute of frauds, estoppel, illegality, usury, waiver, abandonment of lien, merger of title, payment, accord and satisfaction, fraud, etc. A full discussion of the rights of the Trustee are found in Remington on Bankruptcy, (2nd. Ed.) Sections 1137-1497.

See

Moore vs. Crandall, 205 Fed. 689, (9 C. C. A.).

Wells vs. Lincoln, 214 Fed. 227, (9 C. C. A.).

Pacific States Bank vs. Coats, 205 Fed. 618, (9 C. C. A.).

In re Bement, 172 Fed. 98, (C. C. A. 8).

In re Omaha Motor Car Co., 245 Fed. 546, (C. C. A. 8).

In re Standard Telephone & Elec. Co., 216 U. S. 545, 24 A. B. R. 761.

Conclusion. Since the Referee found the bankrupt was insolvent in the bankruptcy sense and that all payments were made within four months, this case falls within Sec. 67-E and therefore within the provisions of Sec. 67-G, but the foregoing authorities conclusively show that the Trustee may rely on Sec. 70-E alone for the purpose of making objections to claims filed with the Referee.

INSOLVENCY UNDER STATE LAW.

Counsel for Bank does not dispute the rule laid down in our opening brief that a corporation is insolvent in the State of Washington when it is unable to pay its bills as they mature in due course of business, except Counsel says:—

> "We believe the real test of insolvency is general inability to pay its debts in due course of business and not mere inability to pay one or a few of its debts."
>
> (Bank brief, p. 26).

Counsel for Carson, Pirie Scott & Co. disputes the rule relying on the early decisions of the Supreme Court. It may be observed that the court in its early history uttered expressions to the effect that a corporation was not insolvent although its liabilities exceeded its assets and it was unable to pay its debts in due course, if the corporation was a going concern and intended to continue in business. Counsel cites

Leslie vs. Wilshire, 6 Wash. 282, 33 Pac. 505.

Vincent vs. Snoqualmie Mill Co., 7 Wash. 566, 35 Pac. 396.

Smith vs. Hopkins, 10 Wash. 77, 38 Pac. 854.

Biddle Pur. Co. vs. Port Townsend Steel Co., 16 Wash. 681, 48 Pac. 407.

The idea that the intent of the corporation to continue in business was a controlling consideration was later exploded in

Cook vs. Moody, 18 Wash. 114, 50 Pac. 1020.

The time honored definition of insolvency, the one followed by the Federal Courts prior to the Bankruptcy Act of 1898, that a *corporation is insolvent when it is unable to pay its debts as they mature in due course of business,* was laid down in

State Ex Rel Strohl vs. Superior Court, 20 Wash. 545, 56 Pac. 35.

Owing to the special facts stated in the opinion a somewhat different rule was laid down in

Strohl vs. Seattle National Bank, 25 Wash. 28, 56 Pac. 35.

In 1909, the rule that a corporation is insolvent when it is unable to meet its bills as they mature in due course of business was again stated in

Nixon vs. Hendy Machine Works, 51 Wash. 419, 99 Pac. 11

and has been uniformly followed since.

See

McKay vs. Sperry Flour Co., 95 Wash. 209, 163 Pac. 377.

Ronald vs. Schoenfield, 94 Wash. 238, 162 Pac. 43.

Simpson vs. Western Hdw. & Metal Co., 97 Wash. 626, 167 Pac. 113.

Jones vs. Hoquiam Lbr. & Shingle Co., 98 Wash. 172, 167 Pac. 117.

McKnight vs. Shadbolt, 98 Wash. 665, 168 Pac. 473.

It seems to the Trustee that there is no room for argument or any doubt that the test of insolvency of corporations, so far as the rights of

creditors are concerned, is inability to pay debts as they mature in due course of business

GOING CONCERN.

Appellees argue that the trust fund theory has never been applied by the Supreme Court of Washington to insolvent corporations, which were going concerns at the time of preference; that an exception is made in favor of corporations which are going concerns. Counsel cite the following cases:

Brooks vs. Skookum Mfg. Co., 9 Wash. 80, 37 Pac. 284.

Leslie vs. Wilshire, 6 Wash. 282, 33 Pac. 505,

Vincent vs. Snoqualmie Mill Co., 7 Wash. 566, 35 Pac. 396.

Smith vs. Hopkins, 10 Wash. 77, 38 Pac. 854.

Biddle Pur. Co. vs. Port Townsend Steel Co., 16 Wash. 681, 48 Pac. 407.

Cook vs. Moody, 18 Wash. 114, 50 Pac. 1020.

An examination of the foregoing cases discloses, we believe, that they are not authorities for the exception contended for by Appellees.

In *Brooks vs. Skookum Mfg. Co., supra*, it appeared that on February 25, 1891, the corporation gave a chattel mortgage on its stock, fixtures and building to secure a *present* loan of $5000. Thereafter the creditor agreed to give an extension and to accept in lieu of the said mortgage a new mortgage which is in controversy. The new mortgage covered stock, plant and buildings, "being in great part the property included in the former mortgage, to secure—First, debt of $4400 being the remainder due upon plaintiff's note and mortgage aforesaid; and second, the *claims of other creditors* amounting to about $4000 whose claims are set out in detail in the mortgage. Whereupon the plaintiff cancelled the former mortgage of record." The court found that the liabilities exceeded assets if the "good will" was not considered; that the business was profitable and paying, that it was holding its own and it was expected would materially increase, that the "good will" was a valuable asset, that the first mortgage was valid and the second covered largely the same property although some additional property was included; that the company although pressed somewhat by creditors could get an extension of all debts then due and that such arrangements were made in a manner satisfactory to all

persons interested. Held that the facts were so dissimilar to those in *Thompson vs. Huron Lumber Co.,* that the rule there laid down did not apply.

Of this case it may be observed that there could be no preference to the creditor because the first mortgage was given for a *present* consideration and was admittedly valid and that the second was a renewal thereof. Second, that the second mortgage covered both the claim of the plaintiff and also the claims of other creditors so that all were treated *equally.* Third, that the arrangements made were satisfactory to all parties interested so that an estoppel existed. Fourth, this case his never been cited or referred to by any court.

Leslie vs. Wilshire, supra, considered a $1700 chattel mortgage executed February 10, 1892, to secure an antecedent debt (milk sold February 1—February 10), a present consideration (release from contract) and future debts (sums to become due February 10-28). It is apparent that there was no preference because the consideration was *partly a present and partly a future consideration.*

In both of the above cases there was no preference under the construction of the trust fund theory adopted by this court in

Coler vs. Allen, 114 Fed. 611, (9 C. C. A. 1902).

Vincent vs. Snoqualmie Mill Co., supra, involved a mortgage given for the *purchase price.* There could be no preference because the consideration was a present consideration and could not cause a diminution of the corporation's assets.

Smith vs. Hopkins, supra, related to a case where the corporation was practically out of business and was in a desperate condition known to all concerned. *This case did not involve a going concern.*

Biddle Pur. Co. vs. Port Townsend Steel Co., supra, did not have under consideration a going concern.

Cook vs. Moody, supra:—

> "The court found that no fraud was intended by Appellant or the company but also found that at the time of the execution of said mortgage said company was unable to pay its debts in the ordinary course of business affairs and was insolvent and would have been compelled to shut down its mill and cease doing business had it not been for the execution of said mortgage and the obtaining of the extension of time of payment of the indebtedness thereby admitted to be secured, all of which was well known to the said C. S. Moody (April 1896) the company continued to operate its

mill until November 15th, following when it shut down and has not done business since." Held, moregage was invalid as a preference.

This case sustains Appellant and applies the trust fund theory to a going concern.

While there are expressions in some of the foregoing cases affording comfort to Appellees, the fact remains that such expressions are *dicta; none of the cases sustains the proposition that an insolvent corporation, while continuing to do business,* may prefer its creditors. In other words, the so called exception has not been recognized in the State of Washington in any of the decisions cited by Appellees.

The true explanation of *Brooks vs. Skookum Mfg. Co., supra,* so strongly relied upon by Appellees, which was decided in 1894 and has never been cited since by any court, and, also the other early cases cited by Appellees, is that these decisions were rendered during the years when the decisions contained expressions that insolvency did not exist even when liabilities exceeded assets or when inability to meet its debts as they matured in due course of business appeared; that insolvency existed only when the corporation had practically ceased business and did not intend to operate further.

See cases cited by Appellees which we have just discussed and are found in early Washington Reports up to Vol. 18. The doctrine of those cases became obsolete upon the adoption of the later rule defining insolvency of corporations as inability to pay their debts as they matured in due course of business in *State Ex Rel Strohl vs. Superior Court,* 20 Wash. 545, 56 Pac. 35, and uniformly followed in all subsequent cases.

See

Nixon vs. Hendy Mach. Wks., 51 Wash. 419, 99 Pac. 11.

Ronald vs. Schoenfield, 94 Wash. 238, 162 Pac. 43.

Simpson vs. Western Hdw. & Metal Co., 97 Wash. 626, 167 Pac. 113.

Jones vs. Hoquiam Lbr. & Shingle Co., 98 Wash. 172, 167 Pac. 117.

McKay vs. Sperry Flour Co., 95 Wash. 209, 163 Pac. 377.

McKnight vs. Shadbolt, 98 Wash. 665, 168 Pac. 473.

On the other hand there are decisions meeting and answering Appellees' point and holding that an insolvent corporation, although a going concern, *cannot prefer* its creditors since all the assets of an

insolvent corporation are a trust fund for the benefit of all its creditors. And the doctrine has been applied to payments of money, deeds, bills of sale, assignment of accounts and transfers of personal property.

Benner vs. Scandinavian American Bank, 73 Wash. 488, 131 Pac. 1149.

Jones vs. Hoquiam Lumber & Shingle Co., 98 Wash. 172, 167 Pac. 117.

Simpson vs. Western Hdw. & Metal Co., 97 Wash. 622, 167 Pac. 113.

As said in *Grandison vs. Robertson,* 220 Fed. 85, (C. C. A. 2):

"'The validity of the payment is not made to defend on whether it is made in the ordinary course of business or on whether the creditor has any reasonable ground to believe the debtor insolvent, but simply on whether there is insolvency, actual or imminent, and on an intent prefer."

to prefer.' *Baker vs. Emerson, et al,* 4 App. Div. 348, 38 N. Y. S. 576."

PAYMENTS IN DUE COURSE.

Appellees contend that payments were made in due course of business. Appellant submits that this is true in a superficial sense only. The true condition of the bankrupt from January to May, 1921, was that of a business in process of dissolution and that payments were made in *due course of liquidation.* The record shows that as early as November, 1920, at the conference of Elliott, O'Brien and LeSourd at Seattle that the officers of the now bankrupt agreed to close out the business by selling in bulk to a purchaser, if one could be found, and otherwise to close out the store at retail (R. 50). Pursuant to this plan the bankrupt advertised in the newspapers for a purchaser and carried on negotiations with prospective purchasers.

As between Carson, Pirie Scott & Co. and the bankrupt, the transactions were not in due course of business because Carson, Pirie Scott & Co. refused to do business, refused to sell any merchandise, with the bankrupt after February, 1921, They demanded payment of their account and were paid $4254.11 while the other merchandise creditors re-

ceived nothing on their accounts. The course of dealing between Carson, Pirie Scott & Co., and the bankrupt was manifestly one of liquidation and payments were made as fast as the conversion of assets into money permitted.

The Referee said:—

"It appears that, in about November, 1920, Charles O'Brien and the O'Brien estate were desirous of getting out of the business and sought to have the stock of goods reduced and the debts paid and the business sold out. The witness (the manager) proceeded to do this by putting on sales and running the stock down as best he could and so continued until he left on April 26, 1920" (R. 19).

"The claims filed in this case to date amount to $16,740.29. I have no doubt from this resume of figures that the bankrupt was insolvent in December, 1920, when the manager, as stated, started in to reduce the stock and pay the debts. The manager made every possible effort to reduce the stock which could be made and to pay the debts during January, February, March, and up to April 25 when he abandoned the business and took service with the claimant herein, as he said because he had no further interest in the business.

"In December, 1920, the bankrupt owed for merchandise about $16,240.92and owed the bank $5500, making a known indebtedness of $21,740.92. Its inventory taken about December 31, 1920, was about $26,371.39, about $4000 of which covered fixtures, leaving the net stock about $22,371.39, or about $630.47 more than

the known debts. It would cost, and *did cost more than $630.47 to convert the stock into cash for the payment of the debts. In fact, it cost about $12,000, so that insolvency existed then and never got any better*" (R. 21). (Our italics.)

INSOLVENCY UNDER TRUST FUND THEORY.

In establishing a preference under the Bankruptcy Act insolvency in the sense that liabilities exceed assets must be proved by the trustee; but establishing a preference under the State trust fund theory insolvency in the sense that the debtor corporation is unable to pay its debts as they mature in due course of business, is all that the trustee need establish.

Simpson vs. Western Hdw. & Metal Co., 97 Wash. 626, 167 Pac. 113.

Stellwagen vs. Clum, 245 U. S. 605.

GOOD FAITH OF CREDITOR IMMATERIAL.

Appellees argue that, under the trust fund theory, it is necessary for the Trustee to prove that the creditor had either actual or constructive knowledge that a preference was effected. Appellees fail to cite any case holding that an action has failed because there was no evidence that the creditor had actual or constructive notice that he was receiving a preference. In other words, Appellees fail to cite a single case that want of knowledge or absence of reasonable cause to believe is a good defense.

On the other hand, a case directly in point, expressly held a defense that the transfer was in good faith on the part of both debtor and creditor and that there was no knowledge of insolvency to be unavailing, that a transfer while the corporation is insolvent giving a greater percentage constitutes a voidable transfer.

> *Jones vs. Hoquiam Lumber & Shingle Co.,* 98 Wash. 172, 167 Pac. 117.

> *Simpson vs. Western Hdw. & Metal Co.,* 97 Wash. 626, 167 Pac. 113.

Benner vs. Scandinavian American Bank, 73 Wash. 488, 131 Pac. 1149.

Williams vs. Davidson, 104 Wash. 315, 176 Pac. 334.

SET-OFF.

On this appeal and for the first time the Bank claims the right of set-off as to all payments made it by bankrupt. The Bank never pleaded the right of set-off. It never claimed before the Referee or before the District Court that it had the right of set-off to all payments made it by the bankrupt. The Bank claimed the right of set-off to $143.08, which was on deposit at the time of bankruptcy (R. 99). The case was tried, argued, and submitted by the Bank and by the Trustee on the theory that the Bank claimed that it had a right of set-off to the deposit of $143.08 only. This affirmative defense set up for the first time in the Appellate Court comes too late. Its consideration would work an injustice to the creditors of the bankrupt represented by the Trustee. Had this defense been interposed at the time of trial it would have been competent for the Trustee to meet it by showing that

the balances in the Bank were built up for the purpose of paying the debt due the Bank.

We earnestly urge that this defense cannot be raised for the first time in the Appellate Court; that it is too late to submit such an issue; that Counsel for Bank led the Trustee and the Court to believe that he claimed the right of set-off as to the deposit of $143.08 only; that by his conduct he has waived the defense of set-off as to payments made to the Bank and that it would be a manifest injustice to take the position that the Bank took in the lower court and then make such a contention in the Appellate Court when the opportunity to meet it by evidence has passed.

> "Subject to a few exceptions, which will be noticed hereafter, the rule is of almost universal application that questions, of whatever nature, not raised and properly preserved for review in the trial court, will not be noticed on appeal. And a *fortiori,* where counsel declares on the trial in open court that only a certain question is involved in the case, or where, by stipulation, the case is submitted only on a certain question, other questions cannot be raised in the appellate court. In some jurisdictions there are express statutory declarations to the effect that questions of which a review is sought must be raised in the court below."
>
> 2. "While the above stated general rule is supportable upon a number of considerations, it is usually placed upon the ground that the

> opposite party should have the proper opportunity to avoid, by amendment or by supplying any defects in his proof, the effect of the objection."
>
> *3 C. J.* 689.

B. GROUNDS OF DEFENSE OR OPPOSITION. (1) *In General.* The rule that questions not raised in the lower court will not be considered in the appellate court is more frequently applied to a variety of instances which may, for the sake of convenient reference, be grouped under the head of grounds of defense or opposition, the general rule in such cases being that if a defendant in the trial court, by failure to plead, to request instructions or introduce evidence, to object to instructions or evidence, or otherwise, fails to present a defense which he might make, and submits issues not involving it, he will be bound in the appellate court by the case made by the pleadings and evidence as exhibited by the record, and cannot urge a defense which was not presented in the lower court. This is especially true where the defense which is sought to be urged in the appellate court is inconsistent with the defense or defenses relied upon in the court below.

OPPOSITION TO DEFENSE. On the same principle, where a defense was made in the trial court

and sustained, grounds of opposition hereto cannot, as a rule, be urged for the first time upon appeal.

3 C. J. 695. Also see 3 C. J. 719-723.

If, however, the matter is to be considered by this court the Trustee believes that the record shows that deposits were made in said Bank and balances built up so that the Bank could draw down $500 every four or five days. See pages 42-43-44 of Appellant's opening brief.

We believe, the record shows that the payments made the Bank were made upon the specific understanding that the bankrupt should put on a special sale, deposit the money in the Bank so that same might be applied.

In fact, Mr. LeSourd told Mr. Donohue, Vice-President of the Bank, on April 26, that the Bank should not expect the bankrupt to pay everything that was taken in at the store on the Bank's claim (R. 35-36). We believe that the sums paid to the Bank by check were actual payments made and not the exercise of the right of set-off under the decision of this court and the cases cited in the opinion.

First Natl. Bank of El Centro vs. Harper, 254 Fed. 641.

PRESUMPTION FROM NON-PRODUCTION OF LETTERS.

This presumption applies to non-production of letters, documents and chattels as well as failure to produce available oral testimony.

22 C. J. 114.

Of course, the presumption is always stronger when a *subpoena duces tecum* or notice to produce has been served. Counsel for Appellees have cited only three cases holding that service of such a subpoena or notice to produce is necessary in order to obtain the benefit of the presumption, notwithstanding the fact that the rule was announced two hundred years ago.

Wigmore on Evidence, sec. 285, says:—

> "The non-production of evidence that would naturally have been produced by an honest and therefore fearless claimant permits the inference that its tenor is unfavorable to the party's cause. Ever since the case of the chimney sweeper jewel this has been a recognized principle."

ADDITIONAL AUTHORITY ON BANKRUPTCY PREFERENCE.

In addition to the authorities cited on pages 17 and 18 of our opening brief is

Herron vs. Moore, 208 Fed. 134 (9 C. C. A.).

EQUALITY.

One of the chief purposes of the Bankruptcy Act is to secure equality in the distribution of the assets of the bankrupt among its creditors.

Healy vs. Wehrung, 229 Fed. 686 (9 C. C. A.).

The philosophy underlying the Act is that under insolvency the assets are impressed with a trust for the benefit of creditors; that the assets are a trust fund for the equal benefit of all creditors.

Remington, 2nd Ed. Section 1274.

The trust fund theory is a theory of courts of equity adopted to prevent fraud, favoritism and unjust discrimination upon the part of corporations

in their relations with their creditors. Its intent and purpose is to secure a just and equal distribution of the assets of insolvent corporations among its creditors. This doctrine is stated at length and in detail in

Conover vs. Hull, 10 Wash. 673, 39 Pac. 166.

In *McKnight vs. Shadbolt,* 98 Wash. 665, 167 Pac. 473, the court said:—

> "There is no reason, either in law or equity, why a party to a preferential transaction should be protected."

The Trustee respectfully submits that his objections were well founded under both the Bankruptcy Act and under the State law.

Respectfully submitted,

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Attorney for Appellant.